

EX PARTE OR LATE FILED



Whitney Hatch
Assistant Vice President
Regulatory Affairs

GTE Service Corporation
1850 M Street, N.W., Suite 1200
Washington, D.C. 20036
202 463-5290

October 28, 1996

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W. Room 222
Washington, D.C. 20554

RECEIVED
OCT 28 1996
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

**EX PARTE: Federal-State Joint Board on Universal Service
CC Docket No. 96-45**

Dear Mr. Caton:

GTE has proposed an auction mechanism for determining universal service support in the captioned docket. GTE believes that an auction mechanism is the most efficient means for establishing funding levels and will best facilitate the entry of multiple carriers competing for universal service support. Prior to competitive entry, however, GTE advocates the use of a cost model to distribute actual costs on a Census Block Group basis.

In response to questions raised by Commission Staff, GTE has prepared the attached memorandum demonstrating why the Telecommunications Act of 1996 requires the Commission to base universal service funding on actual costs as opposed to theoretical measures derived from proxy models. As detailed in the memorandum, the 1996 Act requires universal service support to be explicit and sufficient to preserve and advance Congress's many universal service objectives. Neither total-service, long-run incremental cost ("TSLRIC") nor total-element, long-run incremental cost ("TELRIC") satisfies these statutory directives.

Please feel free to call if you have any questions regarding this matter.

Sincerely,

Whitney Hatch

Attachment

cc: Federal State Joint Board Commissioners and Staff
G. Keeney
W. Kennard

No. of Copies rec'd 04
List ABCDE

THE TELECOMMUNICATIONS ACT OF 1996 REQUIRES THE COMMISSION TO BASE UNIVERSAL SERVICE FUNDING ON ACTUAL COST

The Telecommunications Act of 1996 ("1996 Act") requires universal service support to be "explicit and sufficient to achieve the purposes of" the 1996 Act's universal service objectives.¹ Certain parties in this docket have suggested that the Commission and Joint Board can satisfy the 1996 Act's requirements by basing universal service support on the total-service, long-run incremental cost ("TSLRIC") of local telephone service or total-element, long-run incremental cost ("TELRIC"). For example, AT&T has recommended in ex parte contacts² that the Joint Board and the Commission base universal service support on the TSLRIC of local telephone service calculated using the TELRIC standard for unbundled network elements that the Commission developed when it implemented the 1996 Act.³ More specifically, AT&T uses the proxy costs that the FCC adopted for the TELRIC standard to approximate TSLRIC and to determine the amount of subsidy per line and the size of the universal service fund. Similarly, MCI has advocated the use of TELRIC to establish funding support levels.

Contrary to these suggestions, under the 1996 Act it is neither necessary nor appropriate to base universal service support on TELRIC or TSLRIC. Because TELRIC does not measure the cost of providing any discrete service, TELRIC under any definition could not be used to determine funding support levels. The assumption of AT&T and MCI that there is a direct linkage between the TELRIC prices of unbundled elements and the support required for local telephone service is therefore misplaced. Even if TSLRIC were the proper standard to determine universal service support, the TSLRIC standard proposed by AT&T and MCI in this proceeding is not consistent with the 1996 Act because it would not permit the recovery of a reasonable share of the joint and common costs related to providing universal service. As set forth below, the 1996 Act requires the Commission to adopt an actual cost standard for determining universal service support.

I. The Use Of TELRIC Or TSLRIC To Establish Universal Service Support Is Contrary To The 1996 Act

The 1996 Act's universal service provisions do not require universal service support to be based on the same standards applicable to the 1996 Act's interconnection and unbundling requirements. Instead, universal service support must be sufficient to achieve the 1996 Act's many universal service objectives, including the preservation and advancement of universal service at affordable rates. Neither TELRIC, nor its predecessor TSLRIC, would suffice to meet the 1996 Act's requirements.

Section 252(d)(1) of the 1996 Act sets forth specific pricing standards that the state commissions⁴ must apply to the interconnection and unbundling obligations

¹ 47 U.S.C. § 254(e).

² See, e.g., Letter of Bruce K. Cox, AT&T Government Affairs Director, to William F. Caton, Acting Secretary, CC Docket No. 96-45 (Sept. 12, 1996).

³ See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, FCC No. 96-325 at ¶ 678 (released Aug. 8, 1996) ("Interconnection Order").

⁴ As GTE has demonstrated before the Commission and the Eighth Circuit, see, e.g., Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, Joint Motion Of GTE Corporation And The Southern New England Telephone Company For Stay Pending Judicial Review at 6-12 (filed Aug. 28, 1996) ("Joint Motion"); GTE Service Corp. v. Federal Communications Commission, Eighth Cir. Case No. ___, Motion For Stay Pending Judicial Review And For Expedited Judicial Review (filed Sept. 16, 1996), the 1996

contained in Section 251(c)(2) and Section 251(c)(3). Section 252(d)(1) provides that rates for interconnection and unbundling must be “based on cost and nondiscriminatory, and may include a reasonable profit.” Although the Commission’s TELRIC standard cannot be considered an appropriate interpretation of the Section 252(d)(1) standard because the 1996 Act did not contemplate the use of an incremental cost methodology with respect to pricing interconnection and network elements⁵ and TELRIC would not provide constitutionally adequate compensation,⁶ the 1996 Act clearly mandates that pricing for interconnection and unbundling be “based on cost.”

In contrast to Section 252(d)(1), the 1996 Act’s universal service provisions do not require that universal service support be based on the cost standards applicable to interconnection and unbundling. Instead, universal service support must be “explicit and *sufficient* to achieve the purposes of [Section 254],”⁷ which include, among others, the preservation and advancement of universal service; the availability of quality services at just, reasonable, and affordable rates; access to advanced services in all regions of the Nation; and access to telecommunications and information services by consumers in rural, insular, and high-cost areas at rates that are reasonably comparable to rates that are charged for similar services in urban areas.⁸ Although the statute does not define “sufficient,” the term’s conventional meaning is “as much as needed; enough; adequate.”⁹ The TELRIC standard adopted by the FCC in the Interconnection Order would by no interpretation satisfy this statutory standard.

A. TELRIC Would Not Measure The Costs Of Providing Universal Service

In Section 254(c), Congress directed the Joint Board and the Commission to define a set of services that a telecommunications carrier must provide to be eligible for Federal universal service support.¹⁰ The Commission itself concedes that the TELRIC methodology, although a version of TSLRIC, measures costs associated with distinct network facilities rather than entire telecommunications services. Interconnection Order at ¶ 678. Without further analysis, the Commission must reject the use of TELRIC to determine universal service support because TELRIC does not purport to measure the costs associated with offering any service as a whole.

B. TSLRIC Would Not Preserve Or Advance Universal Service

TSLRIC is generally defined as the additional cost incurred by a company to produce an entire output of a particular service, holding constant the production of all

Act does not give the Commission the authority to prescribe national pricing standards for interconnection and unbundling agreements between incumbent local exchange carriers (“ILECs”) and competing carriers. Section 251 provides only that rates for interconnection and unbundled network elements be “just and reasonable.” See 47 U.S.C. §§ 251(c)(2)(D), (c)(3). There is nothing in the general language of Section 251 to suggest that the Commission has the authority to define rates for interconnection and unbundling under the 1996 Act. In addition, TELRIC would not represent a constitutionally permissible methodology for prescribing rates for interconnection and unbundling.

⁵ Compare *id.* at § 252(d)(2)(A)(ii) (reciprocal compensation for transport and termination must be based on “a reasonable approximation of the additional costs of terminating such calls”) (emphasis added) with *id.* at § 252(d)(1)(A) (interconnection and network element charges “shall be based on the cost...of providing the interconnection or network element”) (emphasis added).

⁶ Joint Motion at 12-18.

⁷ 47 U.S.C. § 254(e) (emphasis added)

⁸ *Id.* at §§ 254(b)(1), (b)(2), & (b)(3).

⁹ *The American Heritage Dictionary*, Second College Edition.

¹⁰ See 47 U.S.C. §§ 254(c), 214(e)(1)(A).

other services of the company. TSLRIC studies forward-looking costs, ignoring current investment levels and a substantial portion of the common overhead costs of the firm.

Under Section 254, the Commission must preserve and advance universal service.¹¹ The Commission could not preserve universal service by basing universal service subsidies on TSLRIC because, by definition, TSLRIC would not measure the current cost of sustaining universal service. As the Commission details in the Interconnection Order, TSLRIC is a forward-looking cost methodology that does not account for past investments made by carriers to provide universal service. Interconnection Order at ¶¶ 672, 713 (non-cost based charges for universal service subsidies will not be included in rates for interconnection and unbundling). No cost calculation that relies on the TSLRIC methodology could be sufficient to preserve universal service.

TSLRIC would also not “advance” universal service as required by Section 254.¹² Under the 1996 Act, Congress specifically permitted multiple carriers to provide universal service as long as they qualified under state and federal law.¹³ The 1996 Act requires universal service support to be explicit rather than implicit,¹⁴ and that prices for supported universal services be “affordable”¹⁵ and “reasonably comparable” in urban and rural areas.¹⁶ Thus, according to the 1996 Act carriers may not impose the excess costs of serving high-cost areas on customers in low-cost areas. As formulated by AT&T and the Hatfield model, TSLRIC fails to account for a reasonable share of the joint and common costs associated with providing universal service to end users. Universal service support based on a TSLRIC methodology that would require carriers to obtain the unrecovered joint and common costs of providing universal service through implicit subsidies on other services is fundamentally at odds with the 1996 Act. This would be contrary to the 1996 Act’s requirement that universal service support be explicit.

The use of the TSLRIC cost methodology for universal service support would also not be sufficient as required by the 1996 Act.¹⁷ As stated above, TSLRIC as formulated by AT&T and the Hatfield model does not permit carriers to recover a reasonable measure of their joint and common costs. Indeed, depending on the cost model adopted, TSLRIC typically does not include plant-specific expenses such as network support, general support, and general purpose computers; plant nonspecific expenses; general support assets such as furniture, office support equipment, and company communications equipment; land and buildings; corporate expenses; and other taxes and fees such as local franchise taxes, federal superfund taxes, and local and state business license and occupation taxes. Not only would the exclusion of these expenses result in funding that is insufficient, it would contravene the plain language of Section 254(k), which permits services supported by the universal service fund to bear a “reasonable” share of joint and common costs used to provide those services.¹⁸ As

¹¹ Id. at § 254(b); see also id. at § 254(d) (every telecommunications carrier must contribute to the funding mechanisms established by the Commission “to preserve and advance universal service”).

¹² Id. at § 254(b).

¹³ See id. at §§ 214(e)(1)-(2) (state commissions can designate multiple eligible telecommunications carriers, who may qualify for universal service support “in accordance with Section 254”).

¹⁴ H.R. Conf. Rep. No. 458, 104th Cong., 2d Sess. 131 (1996).

¹⁵ 47 U.S.C. § 254(b)(1).

¹⁶ Id. at § 254(b)(3).

¹⁷ Id. at § 254(e).

¹⁸ Id. at § 254(k).

proposed, the TSLRIC cost methodology could not be used to determine universal service subsidies consistent with the 1996 Act.

C. The AT&T and MCI Proposals Would Compromise Universal Service

Contrary to the expressed intent of Congress, AT&T's use of the TELRIC proxies to estimate the necessary subsidy per line simply would not support the provision of universal service. To derive TSLRIC, AT&T combines the proxy costs that the Commission has surmised approximate TELRIC with the retailing costs to end users that TELRIC excludes. Although presumably AT&T uses this formulation as a short-hand method to determine TSLRIC, GTE believes that AT&T's arbitrary calculations illustrate the hypothetical and abstract nature of the use of any proxy cost methodology. For these reasons, GTE does not support the use of cost proxies as promulgated by the FCC in the Interconnection Order, by AT&T in its ex parte, or through the use of the Hatfield model that AT&T has proffered in this and other proceedings.¹⁹ In any event, as demonstrated above, AT&T's reliance on TSLRIC for determining universal service support is misplaced.

As an initial matter, AT&T's calculations are based upon proxy costs that do not even reflect TELRIC under the FCC's own definition of TELRIC. For example, GTE's computation of TELRIC for all features and functions related to end office switching used for local service is much higher than the \$0.002-.004 used in AT&T's analysis -- about \$0.015 even without common costs. Further, GTE's USF Weighted Loop Cost is as much as 56% higher than local rate proxy ceilings set by the Commission. GTE has estimated that if it were forced to re-price all network elements using the FCC's proxy rates, a \$2.8 billion shortfall would result for the GTE system as a whole.

Requiring universal service support levels to be based on the FCC's TELRIC proxy levels, or even at TSLRIC as proposed by AT&T, would seriously undermine GTE's ability to fulfill its carrier of last resort obligations and the provision of universal service to all subscribers in its franchised territories. Support at the "below cost" levels, as suggested by AT&T, would also undermine GTE's ability to provide advanced telecommunications services to local schools and libraries, as well as the provision of public interest payphones. Finally, given that investment decisions are dependent on anticipated levels of revenue and profit, establishing universal service support levels at TSLRIC would provide disincentives for GTE shareholders to invest in network infrastructure.

II. **Because It Is Market-Driven And Will Preserve And Advance Universal Service, The Commission Should Adopt GTE's Universal Service Proposal**

GTE's proposal for determining universal service support is far superior to AT&T's recommended method. By basing universal service support on actual costs distributed on a Census Block Group ("CBG") basis prior to competitive entry, GTE's proposal will preserve universal service. With the advent of competition, GTE's proposal will also advance universal service through an auction mechanism, which will permit market forces to govern entry decisions. Not only is GTE's auction mechanism more

¹⁹ A cost model may be appropriate to distribute actual costs on a study area level for the purpose of deaggregating costs according to Census Block Group areas. GTE's universal service proposal would employ this method to set initial costs.

competitive and efficient than AT&T's TELRIC or TSLRIC proposal, it also comports with the 1996 Act.

A. Support Must Be Based On Actual Costs To Preserve Universal Service

In principle, the market price in a given market will be based on the average cost of suppliers in the industry. A market firm would establish its price by applying a mark-up over incremental cost (based on existing capacity levels) to cover the total cost of the firm. The size of this mark-up would depend on the level of the firm's costs and on demand characteristics. The only current experience with the actual costs of providing local telephone service is captured in the reported costs of existing incumbent local exchange carriers, which provide the bulk of the supply capacity in the industry today. Unlike actual cost, TSLRIC models are generally used to make determinations about relative prices by attempting to estimate a forward-looking total cost for the firm under alternative hypotheses. As demonstrated above, TSLRIC by definition does not provide for the recovery of common costs.

AT&T asserts that universal service support be established solely on the basis of results from forward-looking costs models such as the Hatfield model, which purport to measure TSLRIC using the most efficient technology and network design. The Hatfield or similar models, however, use unreasonably low investment and expense estimates and pretend that perfect networks can materialize overnight, producing such low universal service support that there would be no incentive for network investment. If technology makes possible a lower cost on a forward-looking basis, this fact, in and of itself, will not change the market price set, as suggested above, on the average cost of suppliers in the market today. The price will change only as firms actually install capacity to produce at the lower cost.

Because the Federal universal service funding mechanism must be sufficient to preserve universal service,²⁰ GTE believes that it is the overall cost of the firm that is relevant to determining universal service support. The estimate of market price at the outset of the new universal service plan should be based on the cost of the capacity that is actually used to supply the market at that time, including a contribution to the common cost recovery of the business. This would provide the correct incentives for new firms to enter the market if they can supply at lower cost.

B. GTE's Auction Mechanism Will Advance Universal Service

Under GTE's auction proposal, if market entrants view the ILEC's costs as too high, they may bid them down to establish a market rate. If, on the other hand, new entrants believe that the ILEC's costs are too low, bidders could drive them up to their economic rate. Costs would equalize over time to reflect market considerations. Efficiency rather than regulatory fiat would drive down the total size of the universal service fund. In either instance, costs are driven by market forces rather than artificial cost methodologies, which by their nature are subject to controversy.

Unlike an auction mechanism that would adjust support requirements to competitive market levels over time, relying on cost proxy estimates to set support levels would deter competitive entry because insufficient support would give inappropriate

²⁰ Id. at § 254(b)(5).

entry signals to new entrants. Further, GTE's plan alleviates the need for regulators to engage in never-ending debates on the design and selection of an appropriate cost model, and the need to rely on such models, to determine annual support levels.